

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matters of

Ameritech Corporation Telephone Operating
Companies' Continuing Property Records Audit

CC Docket No. 99-117

Bell Atlantic (North) Telephone Companies
Continuing Property Records Audit

ASD File No. 99-22

Bell Atlantic (South) Telephone Companies
Continuing Property Records Audit

BellSouth Telecommunications' Continuing
Property Records Audit

Pacific Bell and Nevada Bell Continuing
Property Records Audit

Southwestern Bell Telephone Company's
Continuing Property Records Audit

US WEST Telephone Companies' Continuing
Property Records Audit

REPLY COMMENTS OF SBC COMMUNICATIONS INC.

AMERITECH OPERATING COMPANIES
SOUTHWESTERN BELL TELEPHONE COMPANY
PACIFIC BELL
NEVADA BELL

ALFRED G. RICHTER, JR.
ROGER K. TOPPINS
JONATHAN W. ROYSTON

One Bell Plaza, Room 3005
Dallas, Texas 75202
214-464-5534

LEANDER VALENT
9525 W. Bryn Mawr, Suite 600
Rosemont, Illinois 60018
847-928-4396

Attorneys for SBC Communications Inc.
and its Subsidiaries

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Summary*

AT&T and MCI have not been able to brush aside the serious questions about the manner in which these audits were conducted. The SBC LECs, other RBOCs, and independent statisticians and accountants at three major accounting firms have identified serious deficiencies in the statistical methodology and in the failure to follow basic principles of the applicable accounting standards. In view of these deficiencies, the audit results are extremely inaccurate and useless.

AT&T and MCI attempt to downplay the significance of the statistical flaws by contending that the most relevant statistic is the "point estimate" at the center of the confidence interval. However, a "point estimate" is only as good as the margin of error. In these audits, the margins of error in the dollar estimates are incredibly wide. To say, for example, as the SWBT audit report does, that the overstatement of account balances is between \$105.3 million and \$338.1 million, i.e., somewhere within **53%** of the point estimate, indicates that the estimates are utterly unreliable and meaningless. The primary cause of these unacceptably wide margins of error is the failure to consider dollar values in the sampling process.

Under the circumstances of these audits, the relevant dollar value is the lower bound of a confidence interval, not the point estimate. That is the only number that is appropriate in testing for overstatements, especially given that no number within the wide confidence intervals is any more likely than any other and the FCC auditors had control over the design of the audit and the resulting imprecision. By using a lower bound, one can say, with the chosen level of confidence,

* The abbreviations in this Summary are defined in the body of these Reply Comments.

that the true value is at least that amount. AT&T recognizes that a 95% confidence interval is commonly used, but that is only under ordinary circumstances. In this case, there were numerous nonsampling errors and bias that cannot be quantified but cannot be ignored either. Thus, a higher confidence level should be used and EY recommends a 99% confidence level.

All of AT&T's and MCI's attempts to downplay the significance of these statistical errors cannot obscure the fact that the huge margin of error in the dollar estimates causes any conclusions to be highly questionable. In fact, the dollar results are so poor and imprecise in some cases that the margin of error exceeds the point estimates, resulting in a negative lower bound. This means that the statistical procedures were so imprecise that they cannot support a conclusion that the value of "not found" equipment was other than zero or a relatively low number.

In addition, failure to conduct a two-way audit, i.e., checking for equipment that was listed without checking for equipment that was in the central office but not on the list (unrecorded equipment), makes it impossible for the auditors to express an accurate opinion on the net value of the overstatement in the account balances. MCI and AT&T are wrong to claim that there is not any significant unrecorded equipment, as shown by the example cited by MCI where Bell Atlantic found 27% as much unrecorded equipment as there was overstated equipment. The SAVR inventories at SWBT and Pacific Bell likewise show that there are significant amounts of unrecorded equipment relative to the amount of "not found" equipment.

The field audits and rescoring were not conducted in a manner that was "overly generous" to the RBOCs, as AT&T and MCI allege. Quite the contrary, the auditors' procedures were overly restrictive, poorly planned and did not comply with applicable accounting standards, such as GAAS and/or GAGAS. The field audits were conducted in a manner that did not allow

sufficient time to locate all 36 items at each office and the RBOCs had no idea that the field audits would be their only opportunity, in almost all cases, to convince the auditor that an item should be scored as “found.” During the rescoring process, the auditors applied “secret” standards (which were only disclosed many months after the fact), while refusing to engage in any dialogue with the RBOC staff, to investigate the RBOCs’ evidentiary submissions or to pursue any other additional procedures, such as return visits to field locations. This is contrary to GAAS, which requires the auditor to fully investigate all information he or she becomes aware of, including information provided by management.

AT&T defends the limited audit procedures by claiming that this was a “special purpose” rather than a comprehensive audit, and that it is akin to an “agreed-upon procedures” engagement. While AT&T may be able to show that the procedures of such a limited engagement were followed, in doing so, AT&T has shown, as the RBOCs have been claiming all along, that the audit procedures were too limited and deficient to render an opinion on the hardwire account balances.

Even if the FCC auditors had properly planned and conducted the audit to avoid all of these problems, the results would still not have any impact on rates under a proper application of price cap regulation. The Snively Report claims that delayed retirements cause an overstatement of depreciation expense, but as the SBC LECs’ regulatory accounting experts demonstrate in the Knox/Gleason Declaration attached as Exhibit “C”, this is not the case. In a simple example, the SBC LECs show that depreciation expense remains unchanged. When more specific assumptions are used, one finds that delayed retirements actually may have caused depreciation expense to be understated in previous years.

The Snively Report’s claims that some of the “not found” equipment never existed, and

that, as a result, both the rate base and depreciation expense were overstated. However, the auditors did not contend that assets never existed, nor did they perform any procedures to be able to reach such a conclusion. For instance, they did not even review the RBOCs' internal controls. Thus, the Snavely Report has nothing but speculation to support this theory.

AT&T's and MCI's two theories do not provide any basis to find any impact on current revenue requirements. And, even assuming there could be an impact on current revenue requirements, an audit of property records as of 1997 does not provide any rational basis to reach any conclusions concerning the status of the records or the account balances in any prior period.

AT&T's contention that the RBOCs must be forced to remove the undetailed investment from their records "immediately" is inconsistent with the history of this special category of investment created in the late 1960s under accounting procedures prepared by AT&T and filed with the FCC. In approving a new mechanized property record system in a December 1968 ruling, the FCC accepted these AT&T procedures as the appropriate method of handling undetailed investment. And, in weighing the benefits of the new mechanized system against the costs of converting all of the embedded records, the FCC allowed undetailed investment to continue to exist. It would be unreasonable to be so concerned about this class of equipment in 1999, in our current regulatory environment, when the approach in 1968 was simply to permit the pre-existing records to remain undetailed in the new property record. Besides, AT&T cannot honestly claim that all undetailed investment must be considered "missing" given that, at divestiture, AT&T transferred control of much of the then existing undetailed investment to the RBOCs, including, for example, virtually all of the hardwire equipment at SWBT (about \$6 billion).

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REPLY COMMENTS OF SBC COMMUNICATIONS INC.

SBC Communications Inc. hereby submits these Reply Comments on behalf of the Ameritech Operating Companies ("Ameritech")¹, Southwestern Bell Telephone Company ("SWBT"), Pacific Bell and Nevada Bell (collectively, all referred to herein as the "SBC LECs")

¹ Ameritech Operating Companies means: Illinois Bell Telephone Company, Indiana Bell Telephone, Incorporated, Michigan Bell Telephone, The Ohio Bell Telephone Company and Wisconsin Bell, Inc. Ameritech filed separate comments prior to the October 8, 1999 closing of the Ameritech/SBC merger. These Reply Comments are filed on behalf of all of the SBC LECs whose property records were audited, including the Ameritech Operating Companies.

to respond to the public versions of the comments filed by AT&T Corp. (“AT&T”) and MCI WorldCom (“MCI”)² on September 23, 1999 concerning the Notice of Inquiry (“NOI”)³ in the above-captioned proceeding.

I. INTRODUCTION.

Predictably, the RBOCs’ competitors’ comments take positions that are diametrically opposed to those of the RBOCs. It is also no surprise that AT&T and MCI must resort to inflammatory language and play loose with the facts in order to make their positions sound better than they really are. AT&T goes too far, however, when it says that the RBOCs’ statisticians, who work for the largest, most reputable accounting firms in the country, should receive an “F” in statistics.⁴ In contrast, the SBC LECs have not questioned the professionalism of any of the FCC staff or auditors, as AT&T alleges.⁵ However, the SBC LECs have raised serious questions about the manner in which these audits were conducted. This is not intended as an attack against the auditors; rather, these are objections to the fairness of these audits.⁶ Professionalism is not the issue nor are “phantom assets and phantom costs,”⁷ “bilking”⁸ customers, “disgorg[ing]. . . illegitimate gains,”⁹ or “bogus”¹⁰ investment. When AT&T and MCI’s comments are stripped of

² Comments filed in this proceeding are cited by the abbreviated name of the commenters (e.g., “MCI at 1.”). The RBOCs’ responses published with the audit reports are cited “[RBOC] Response at ____.”

³ 14 FCC Rcd 7019 (1999) (“NOI”).

⁴ AT&T at 25.

⁵ *E.g.*, AT&T at 2-3.

⁶ *See* NOI, Separate Statement of Harold Furchtgott-Roth, Dissenting in Part at 1, 3, 7-8.

⁷ AT&T at 3.

⁸ *Id.* at 39.

⁹ *Id.* at 35.

¹⁰ *Id.* at 36.

platitudes and their arguments examined more closely, as they are below, one can see that they are completely without merit.

In fact, the SBC LECs object to a procedure where a government agency audit is opened to comment primarily by the auditee's competitors who are not even subject to such audits. Competitors should not be appointed de facto auditors after the fact, nor should they be given access to the detailed, raw data and workpapers of any audit.¹¹ If an agency is not sure of its own auditors' work, as the issues presented for comment in the NOI indicate, then it should retain its own independent expert to review its auditors' work, if not to conduct the entire audit, in a manner that assures that the independence of the auditor is not compromised. In fact, the 1996 Act gave the FCC the authority to hire independent auditors.¹²

A truly independent analysis of these audits would not reach the conclusions that AT&T and MCI advance. It would not conclude that the statistical plan was free of significant problems because it would recognize, among other things, that the extremely wide confidence intervals (up to $\pm 50\%$ or more) reveal a fatal flaw in the precision of the dollar results. It would not claim that a two-way audit is unnecessary to determine the true amount of overstatement of account balances, on a net basis. It would not seek to defend narrow, restrictive field audit and rescoring procedures that applied "secret" standards while refusing to engage in further discussion with the audited company's staff. It would not ignore the lack of importance of costs in determining rates under price cap regulation. And, it would recognize that one cannot reach any conclusions concerning records or account balances in 1990 based on flawed, or even good, audit estimates of 1997 records. It would not claim that the ends justify whatever means are necessary to produce rate reductions, even if those means are contrary to Part 32, price cap regulation or Generally Accepted Auditing Standards ("GAAS"). And, most importantly, it would see that the costs of complying with outdated, excessively detailed rules far exceed the benefits, rather than propose

¹¹ See SBC LECs Application for Review, FOIA Control No. 99-163, filed Aug. 3, 1999.

¹² 47 U.S.C. § 220 (c).

additional, future publicly conducted audits of accounting property records.¹³

In these Reply Comments, as in the SBC LECs' previous filings, the SBC LECs show that because of serious problems with the way these audits were designed and conducted, the results are highly imprecise and unreliable. In any event, even ignoring the serious flaws in the audit results, they should not have any impact on rates under price cap regulation and cannot be extrapolated to prior periods. Nothing that AT&T and MCI says can remedy these problems after the fact and these problems are far more significant than AT&T and MCI are willing to admit in their "disinterested"¹⁴ review of these audits.

II. SERIOUS STATISTICAL DEFICIENCIES RENDER THE AUDIT RESULTS, PARTICULARLY THE DOLLAR ESTIMATES, UNRELIABLE.

Because of the serious problems in the sampling methodology, the audit results are too unreliable to serve as the basis for any corrective action, especially the audit conclusions concerning overstatement of dollar values of the RBOCs' account balances. The SBC LECs and the other RBOCs have explained these deficiencies in detail in their Responses and Comments.¹⁵ The SBC LECs will not repeat all of the details of these problems in these Reply Comments, but this is not intended to suggest that those not mentioned are not significant.¹⁶

AT&T and MCI attempt to downplay the significance of the statistical flaws in these audits by carefully limiting the scope of their discussion. To support this minimizing of the statistical flaws, AT&T relies primarily on the affidavit of Robert M. Bell ("Bell Aff."), a member of AT&T's statistics research department, and to a limited extent on the affidavit of

¹³ AT&T at 39.

¹⁴ *Id.*

¹⁵ *E.g.*, SBC LECs at 5-16, BellSouth at 9-19; US WEST at 8-15 & Attachment 2.

¹⁶ Likewise, the SBC LECs' silence on any particular issue or AT&T argument is not intended to imply that the issue is not important or that the SBC LECs concede the argument, notwithstanding AT&T's belief that silence constitutes an admission. *See* AT&T at 4, 11, 20-21, 26.

James K. Loebbecke (“Loebbecke Aff.”), a retired CPA who specialized in audit sampling. To respond to AT&T’s and MCI’s statistical arguments, the SBC LECs submit as Exhibit “A” to these Reply Comments the Declaration (“Scheuren/Mulrow Decl.”) of Fritz Scheuren, a Senior Fellow at The Urban Institute and a former professor of statistics at George Washington University and Edward Mulrow, a statistician at Ernst & Young LLP (“EY”). Some of Scheuren’s and Mulrow’s points are summarized here.

A discussion of the highly imprecise nature of the FCC’s audit results on dollar values, Scheuren and Mulrow observe, is surprisingly absent from the comments of AT&T, Dr. Bell and MCI.¹⁷ AT&T manages to avoid any discussion of the extremely imprecise dollar estimates reflected in the confidence intervals by contending that the relevant statistic for adjusting account balances is the “point estimate,” not the boundaries of the confidence interval.¹⁸ Thus, Dr. Bell claims that “the best estimate for the amount of [equipment] that is missing is the point estimate.”¹⁹ AT&T explains further that “when a statistician must choose an estimate from within a confidence interval, the most logical choice is a number near the center, *usually* the point estimate.”²⁰

The problem with this line of reasoning is that it ignores the incredibly wide confidence intervals. As Scheuren and Mulrow explain,

An estimate is just that, an *estimate*, not a *true* value. Before utilizing an estimate, one needs to know how precise it is. The confidence level and the margin of error are a means of describing the precision. Confidence bounds, in turn, can be used to judge the validity of decisions based on the sample.

¹⁷ Scheuren/Mulrow Decl., ¶¶2.2-2.3.

¹⁸ AT&T at 25-26 & Exhibit B at 13, ¶36.

¹⁹ Bell Aff. at 13, ¶36.

²⁰ AT&T at 26 (emphasis added).

Dr. Bell would have his readers believe that so long as an estimate is calculated using the right formula out of the right textbook, the estimate is “valid.” This is clearly not true. To be a “valid” basis for action, an estimate not only needs to be calculated using an appropriate formula, but the margin of error must be reasonable.²¹

In the case of these audits, the confidence intervals are incredibly wide, and thus, the accuracy of the estimates is not reasonable and they cannot be relied upon. For example, using a 95% confidence interval, the SWBT audit report estimates that the value of “not found” equipment is somewhere between \$105.3 million and \$338.1 million ($\$221.7 \pm 116.4$ million).²² Thus, according to the audit report, the value is somewhere within 53% of the point estimate. This certainly cannot be considered a reasonable precision level. In fact, the wide interval is especially troubling because no number within the confidence interval is necessarily better than any other,²³ notwithstanding unsupported claims to the contrary.²⁴ It is an extremely unfocused and unreliable assessment of the magnitude of “not found” investment.

Because of these extremely wide margins of error, the point estimates are utterly unreliable and meaningless. As Scheuren and Mulrow explain, “it is highly improbable that one would achieve a similar point estimate using another random sample. . . . The variance is so poor, you cannot expect much stability in the estimates from different random selections. . . .”²⁵ Thus, it is misleading for AT&T and MCI to claim that the RBOCs have not found any “basis to challenge the point estimates.”²⁶ In pointing out that the confidence intervals are extremely

²¹ Scheuren/Mulrow Decl., ¶¶3.1, 3.2.

²² SBC LECs at 28.

²³ Scheuren/Mulrow Decl., ¶5.4.

²⁴ AT&T at 25 n. 16.

²⁵ Scheuren/Mulrow Decl., ¶11.12.

²⁶ MCI at 23. *See* AT&T at 26.

wide, the SBC LECs and the other RBOCs are challenging the reliability of the point estimates directly. Further, other problems discussed in previous filings make these estimates even more unreliable. For example, when one corrects for the degrees of freedom, the lower bound of the confidence level moves even lower, contrary to Dr. Bell's assumption.²⁷ Further, this correction lengthens the confidence intervals by 30 to 50%, not the 6 to 14% that Dr. Bell assumes.²⁸ When these and other problems are corrected and a more conservative 99% confidence interval is used, the lower bound of the confidence interval approaches or goes below zero in the case of some RBOCs.²⁹

The direct cause of the unacceptably wide margin of error for dollar values is the improper design of the sampling process. AT&T and MCI attempt to defend the FCC auditors' design, but it is indefensible as a method of reliably estimating dollar values. If the auditors wanted reliable estimates of overstatements in the account balances, they should have used a statistical sampling method that would provide good results in dollar terms, such as a sample design based on dollar values. Scheuren and Mulrow explain this in detail and quote Mr. Loebbecke's own textbook where he agrees with this basic principle.³⁰ By designing the sample to achieve a reasonable level of accuracy in estimating dollar values, the auditors could still achieve reasonable precision in estimating the percentage of "not found" items as well.³¹

AT&T criticizes other aspects of the RBOCs' statistical analysis of the audits. While none of these other issues is as significant as the unacceptably wide margin of error, several of them have a significant impact. Scheuren and Mulrow respond to these other significant

²⁷ Bell Aff. at 11-12, ¶34. The degrees of freedom determine the width of the confidence interval and are a function of the size of the sample and other factors.

²⁸ Compare *id.* at 11, ¶31 with Scheuren/Mulrow Decl., ¶¶8.1-8.3.

²⁹ *E.g.*, SBC LECs at 8-9; Bell Atlantic Response at 11-12; BellSouth at 18.

³⁰ Scheuren/Mulrow Decl., ¶¶11.1-11.7.

³¹ Scheuren/Mulrow Decl., ¶11.8.

criticisms in their Declaration. Only a few limited comments are included below.

AT&T contends that the lower bound of the confidence interval should not be used to determine the amount of overstatement.³² However, as Scheuren and Mulrow explain,³³ this is consistent with the approach used by the IRS in estimating tax liability (when sampling is required) and is the appropriate method in these audits in view of the following:

- (1) No number within the wide confidence intervals is necessarily better than any other number;
- (2) Since the FCC auditors only conducted a one-way audit, they were only testing for overstatement, and thus, only a one-sided bound is necessary to test for overstatements; and
- (3) the FCC auditors have control over the design of the audit, and thus, the RBOCs do not have the option of doing more sampling to assure better estimates.

By using a lower bound, one can say, with the chosen percentage level of confidence, that the true value is at least that amount.

AT&T and MCI also claim that a 99% confidence level is excessive because standard procedure is to use a 95% confidence level and the FCC adopted a 90% confidence level for statistical evaluation of LEC forecasts in a 1998 decision concerning access tariff filings.³⁴ A 95% confidence interval is adequate under ordinary circumstances and, as AT&T recognizes, is commonly used.³⁵ However, as Scheuren and Mulrow explain, there were special circumstances here that make the use of the 99 percent confidence bound the most appropriate choice, as opposed to the more common 95% interval.³⁶ These include the numerous nonsampling errors

³² AT&T at 25-25 Bell Aff. at 13, ¶¶35-36.

³³ Scheuren/Mulrow Decl., ¶¶4.1-5.7.

³⁴ MCI at 25; AT&T at 27 (citing *1997 Annual Access Tariff Filings*, 13 FCC Rcd 10597, 10602-04 (1998) ("*1997 Annual Access Tariff Order*").

³⁵ AT&T at 5.

³⁶ Scheuren/Mulrow Decl., ¶¶6.1-6.7.

and bias that cannot be quantified but cannot be ignored either. By using a more conservative confidence interval, the auditor remedies the impact of these additional errors. One example of these additional errors was the non-random addition of locations to increase the sample size or assure that a state was represented in the sample.³⁷

The conclusion that the lower confidence bound of the dollar estimates is below zero is not illogical and does not deserve an “F” in statistics, as AT&T alleges.³⁸ As Scheuren and Mulrow explain, this simply means that the results are so imprecise that the margin of error exceeds the point estimate and when the former is subtracted from the latter, the result is negative.³⁹ This does not mean that the true value is zero or below zero; rather, it means that the statistical procedures were so imprecise that they cannot support a conclusion that the value of “not found” equipment is other than zero.⁴⁰

All of AT&T’s and MCI’s attempts to downplay the significance of the statistical problems cannot obscure the most significant problems, such as the extremely wide and unreliable margin of error for the dollar estimates. It is no wonder that they focus on other issues and avoid addressing the enormous width of the dollar estimates’ margin of error. They imply that the statistical errors are minimal by saying, for example, that a mere 6 to 14% adjustment may be required, but nowhere do they dispute that the confidence intervals are much too wide to be used for any purpose.

³⁷ Scheuren/Mulrow Decl., ¶6.4. The *1997 Annual Access Tariff Order* cited by MCI that used a 90% confidence interval is distinguishable because it did not involve any special circumstances such as the nonsampling errors and bias involved here. In addition, in the *1997 Annual Access Tariff Order*, the FCC decided that a 90% interval “is . . . appropriate to this investigation” in view of the circumstances there; it did not adopt that standard for all purposes or for “evaluat[ing] compliance with its rules” generally, contrary to the implication of AT&T’s argument. See *1997 Annual Access Tariff Order*, 13 FCC Rcd at 10603-04 ¶14. Besides, the SBC LECs did not have an opportunity to challenge that decision on appeal.

³⁸ AT&T at 25.

³⁹ Scheuren/Mulrow Decl., ¶¶7.1-7.3.

⁴⁰ SBC LECs at 8-9.

AT&T concludes by saying that Bell Atlantic “has not identified any significant statistical errors that remotely call into question the audit results.”⁴¹ On the contrary, Ernst & Young’s (“EY”) analysis (used by Bell Atlantic, BellSouth and SBC) as well as the other RBOCs’ statisticians’ analyses raised several significant problems, at least four of which have a significant impact on the results.⁴² The most significant of these is the huge margin of error in the dollar estimates, which causes any conclusions concerning overstatement of dollar values to be highly questionable. The bottom line is that the precision of the dollar estimates is so poor that even if the auditors’ scoring is not corrected, the audit results still cannot be used to support a conclusion that the true value of the overstatement is higher than zero or a relatively low, immaterial figure.⁴³

III. FAILURE TO PERFORM A TWO-WAY AUDIT CAUSES THE ESTIMATES OF VALUE TO BE OVERSTATED.

AT&T and MCI both miss the point of a two-way audit to test for both overstatement and understatement of CPR totals or account balances. In order to have a complete assessment of the true value of the account balances, the auditors needed to consider both the equipment that was missing from the central office and the equipment that was missing from the records (“unrecorded equipment”). This is necessary to arrive at an accurate net value.⁴⁴ Without a two-way audit, the audits merely present an overstated gross value.⁴⁵

⁴¹ AT&T at 28.

⁴² See SBC LECs at 5-13 & Exhibit A; Bell Atlantic Response at 9-12; BellSouth at 11-18.

⁴³ For example, the FCC audit results for SWBT merely indicate that there is a 95% probability that the true value of “not found” items is somewhere between \$105 million and \$338 million, but the one-sided 99% value is about \$-40 million.

⁴⁴ See, e.g., SBC LECs at 7 & Exhibit A at 16-17; Bell Atlantic Response at 9; BellSouth at 12-13.

⁴⁵ See Reply Declaration of Carl R. Geppert, attached as Exhibit “B” to these Reply Comments, at 7-8 (“Geppert Reply Declaration”).

MCI objects to a two-way audit because, it says, ratepayers are only harmed by missing equipment, not unrecorded equipment.⁴⁶ However, assuming the question is to what degree ratepayers have been harmed, both values are essential to arrive at a net impact (assuming there were any impact under price cap regulation, which there is not).

MCI also contends that there is no reason to believe that the amount of unrecorded equipment is significant.⁴⁷ However, this depends upon the point of comparison. Relative to total hardwire investment, the amount of unrecorded equipment should not be significant, but unrecorded equipment cannot be ignored in comparison with listed equipment that was “not found.” Despite its claims to the contrary, MCI’s own example shows that unrecorded equipment can be significant compared to equipment retired as a result of an inventory:⁴⁸ Bell Atlantic inventories in 1995 and 1996 resulted in \$291 million in retirements and \$79 million in “reverse” retirements of unrecorded equipment, which unrecorded equipment must be compared to “not found” equipment to evaluate the degree of error in the account balances. This proves that unrecorded equipment cannot be ignored. If there was 27% as much unrecorded equipment as there was overstated equipment in these two Bell Atlantic’s audits, then unrecorded equipment is clearly material in reaching any conclusion concerning overstated account balances.

These Bell Atlantic results as well as the SAVR inventories at Pacific Bell and SWBT show that AT&T and MCI are wrong when they claim that there is not any unrecorded

⁴⁶ MCI at 8.

⁴⁷ *Id.*

⁴⁸ MCI at 8 & n. 14 (citing Bell Atlantic-North Audit Report, ¶32 & n. 47).

equipment or that any such equipment is insignificant.⁴⁹ For example, to date, SWBT's SAVR inventories have identified almost \$120 million of unrecorded equipment that has been added to the account balances.⁵⁰ Obviously, during the audits, Bell Atlantic has furnished proof positive that unrecorded equipment really exists in quantities that are significant compared to the "not found" equipment. Thus, it is unclear how AT&T can claim that Bell Atlantic has not offered a "scintilla of evidence," and thus that the FCC should draw an inference that there is no such equipment.⁵¹

In any event, the FCC's auditors, and not the RBOCs, were in control of the procedures performed in these audits, and given their knowledge of significant unrecorded equipment in the past, this should have led them to use two-way audit procedures.⁵² It is unfair for AT&T to suggest that Bell Atlantic was obligated to perform its own audit procedure at the same time to come forward with more evidence of unrecorded equipment when it had already done so. Surely, this would be an inefficient way for the government to conduct audits: the government

⁴⁹ AT&T at 11; MCI at 8. AT&T also claims that unrecorded equipment is "inherently implausible" because RBOCs have "ample incentive" to book equipment. The SBC LECs refuted this pretext for looking at only "half of the equation" in their Comments in response to the same suggestions made by the Common Carrier Bureau in a letter to Congress. *See* SBC LECs at 7-8 n.15. There are logical reasons for these errors or omissions from the CPR just as there are for erroneous entries. For example, unrecorded equipment can result from retiring too much equipment by mistake. *See also* Geppert Reply Declaration at 8.

⁵⁰ SBC LECs at 7.

⁵¹ AT&T at 11.

⁵² AT&T says that Bell Atlantic's position is that the auditors should have performed "a full-blown inventory of randomly selected offices" to find unrecorded equipment, AT&T at 10-11, but Bell Atlantic's Response did not say that the FCC auditors should be burdened with such a costly, comprehensive inventory. *See* Bell Atlantic Response at 9 (stated "full review" as in a 2-way review). As Scheuren and Mulrow explain, a two-way review can be performed efficiently using "area sampling" within any office for the reverse search for unrecorded equipment. Scheuren Decl., ¶11.9.

and the company each perform half of the field work at each location.

Finally, AT&T claims that Bell Atlantic should be barred by some sort of estoppel from raising the unrecorded equipment as an issue because that would be to defend one unlawful action with another. Even if estoppel were proper in an audit context — and the SBC LECs are not aware of any audit standard that requires an auditor to ignore half the data — the issue of the degree of error in the account balances requires the auditor to consider overstatements as well as understatements. Otherwise, there is an inherent flaw in the incomplete results, as in these audits.

As Dr. Scheuren states,

The only way to determine “missing” equipment would be to take the results of the initial audits and net them against the results of the reverse direction audit. The failure to conduct the reverse audit here means that any quantification of “missing” investment systematically overstates the actual value and cannot be relied on.⁵³

Common sense leads to the inescapable conclusion that it is impossible for the FCC auditors to express a complete and accurate opinion on the RBOCs’ account balances without conducting a two-way audit.

IV. THE FIELD AUDIT AND RESCORING PROCEDURES WERE UNFAIR TO THE RBOCs AND DID NOT FOLLOW GENERALLY ACCEPTED AUDITING STANDARDS.

AT&T and MCI contend that the audits were conducted properly in all respects. In fact, they contend that the auditors were “overly generous” to the RBOCs.⁵⁴ In light of the numerous deficiencies in the audit procedures, discussed in the RBOCs’ Responses and Comments,⁵⁵ the

⁵³ SBC LECs, Exhibit A, at 16.

⁵⁴ AT&T at 13-23; MCI at 12-23.

⁵⁵ *E.g.*, SBC LECs at 16-27 & Exhibit B. US WEST at 8-18 & Attachment 2; BellSouth at 9-23 & Exhibit 5; Ameritech Response at 4-8 & Appendices A-0, A-3, A-5.

SBC LECs do not understand how AT&T and MCI can seriously claim that these audits were conducted properly.

The audits are far from the perfect picture that AT&T and MCI present. As detailed in the RBOCs' Responses and Comments, the auditors' procedures were overly restrictive, poorly planned and did not follow Generally Accepted Auditing Standards ("GAAS").⁵⁶ Without repeating all of the deficiencies described in the previous filings, the SBC LECs wish to highlight some of the major nonstatistical problems that plagued these audits.

The field audits were conducted in a manner that did not allow sufficient time to locate all 36 items at each office. During these field visits, the auditors reached immutable conclusions regarding the scoring of many items. Only the most persuasive evidence had any chance of altering the auditors' field audit scores.⁵⁷ AT&T and MCI's descriptions of the field audits are misleading and incorrect. For example, AT&T says that Bell Atlantic was given advance notice and "could line up any resources it deemed necessary"⁵⁸ and that "Bell Atlantic should have been fully prepared to readily identify all of the selected CPR items."⁵⁹ However, since the RBOCs were not told in advance how restrictive the procedures would be, they had no idea how much resources would be needed at the field audits. Little did they know that these field audits would be their only opportunity, in almost all cases, to convince the auditor that an item should be scored as "found."

AT&T also claims that there was an "exhaustive search," that the RBOC staff was given an "unlimited" opportunity to locate the equipment during the field visits, and that the auditors

⁵⁶ *Id.*

⁵⁷ See SBC LECs at 16-26; Ameritech at 14-18 & Attachment A (Declaration of Carl R. Geppert), at 10-13. See also Reply Declaration of Carl R. Geppert, attached as Exhibit "B" to these Reply Comments, at 8-10 ("Geppert Reply Declaration").

⁵⁸ AT&T at 16.

⁵⁹ *Id.*

“remained at each central office locations until [the RBOC’s] own personnel agreed that the missing items could not be found and that a complete search . . . had been performed.”⁶⁰ Simply, as applied to the SBC LECs, these statements are untrue, as the SBC LEC staff who were present at these field visits can attest.

Typically, the auditors initiated their on-site review at a central office between 8:30 a.m. and 9:00 a.m. Generally, the auditors expressed that their goal was to complete their work and depart by 5:00 p.m. Given time for lunch and an hour or so to review scores at the end of the day, this means that, at most, there was typically about 6 or 7 hours to locate 36 items. Between two auditors, this allowed about 20 minutes per item. In some of the smaller offices, this normally should have been sufficient time to complete the review. However, especially in the larger offices or where problems were encountered, this was not sufficient time to locate all items, given that the RBOC staff did not have access to the list of 36 items until the auditors arrived at the central office.⁶¹ For example, in the case of many items, it was necessary to review engineering drawings and other records or to otherwise investigate an item. It is certainly not true that the auditors stayed at each office until the SBC LEC staff agreed that an item was not found, as AT&T alleges. The most that can be said about any agreement at the conclusion of the one-day field visits is that the SBC LEC staff may have agreed to disagree. Or, in some cases, the parties agreed that further investigation was necessary. And, 20 minutes on the average certainly does not afford the RBOCs an “unlimited” opportunity to locate items, as AT&T alleges.

⁶⁰ *Id.* at 17 & Exhibit C at 4.

⁶¹ *Cf.* Bell Atlantic Response at 2, 6, 10.

MCI and AT&T also mischaracterize the rescoring process. They claim that the auditors allowed “numerous,” “ample” opportunities to submit additional documentation and explanations.⁶² In actuality, the RBOCs had very little chance to convince the auditors to change their initial field audit scores. The unreasonably high and secret standard of proof applied to the rescoring submissions combined with the auditors’ refusal to perform any additional procedures, such as discussion of the reason for specific results with the audited companies’ staff or return visits to some locations, made the chances of obtaining any rescoring extremely unlikely. As all the RBOCs pointed out in their Comments, it was fundamentally unfair for the auditors to keep the rescoring standards a secret until many months after the RBOCs submitted their evidentiary material.⁶³ The auditors should have clearly defined in advance the conditions that must exist for a sampled item to be deemed “not found” and the criteria for rescoring after the field visit.⁶⁴

In fact, contrary to the allegations of MCI and AT&T, the RBOCs were not given a fair opportunity to rescore items that had been misclassified during the field visits. The auditors’ clearly signaled their restrictive approach when they set an initial deadline for submissions within two or three weeks after the field audit results were sent to the RBOCs.⁶⁵ Then, when the SBC LECs sought to discuss the scoring with the auditors, the Audits Branch Chief sent SBC a

⁶² AT&T at 18; MCI at 10.

⁶³ Ameritech at 13 & Attachment A, at 6; Bell Atlantic at 4-5; BellSouth at 21, SBC LECs at 17-19. *See also* Geppert Reply Declaration at 6, 9.

⁶⁴ Geppert Reply Declaration at 10.

⁶⁵ *E.g.*, SBC LECs at 2 & n.3.

letter advising it that no further documentation would be accepted.⁶⁶ While the SBC LECs submitted more documentation, they had no idea whether or how it was being considered because the auditors refused to review the scoring with company representatives.

Even an unlimited opportunity to send documents to the auditors would do nothing to show that the rescoring was conducted fairly if these submissions were to no avail. The auditors rejected the RBOCs' repeated efforts to discuss the scoring results and evidentiary submissions with them. Ameritech even continued this effort when it seemed hopeless after receiving the final draft of the audit report. On February 16, 1999, it submitted a detailed analysis of the rescored field audit results, including over 200 pages of materials.⁶⁷ In the transmittal letter, Ameritech requested a meeting to discuss these materials and noted that the audit staff "has refused to engage in a dialogue on this matter."⁶⁸ Despite these and many other prior RBOC efforts, the auditors refused to engage in any dialogue concerning the rescoring results.

As explained by Arthur Andersen's Carl Geppert, in Exhibit "B" to these Reply Comments, these restrictive field audit and rescoring procedures were inconsistent with applicable Generally Accepted Auditing Standards ("GAAS").⁶⁹ For example, "GAAS require the auditor to investigate all information that he or she becomes aware of, including information

⁶⁶ *Id.* This restrictive approach continued when the FCC staff reluctantly released drafts of the audit reports in July 1998, but required the RBOCs to limit their comments on the drafts to the "correction of factual errors and omissions." *See, e.g.,* Geppert Reply Declaration at 5.

⁶⁷ Letter dated Feb. 16, 1999 from Robin M. Gleason, Ameritech, to Bob Hood, Acting Chief, Audits Branch.

⁶⁸ *Id.*

⁶⁹ *See* Geppert Reply Declaration, at 4-7.

provided by management,”⁷⁰ but the auditors refused to even engage in any dialogue with management on the voluminous data the SBC LECs submitted. Also, the failure to make any return or follow-up visits to any field locations or to otherwise investigate the SBC LECs’ evidentiary submissions to assess their validity is contrary to applicable auditing standards, as is the elevation of the initial one-day field visits to the status of the only competent evidence, as a practical matter.⁷¹ The rescoring standards were also unreasonably narrow, inconsistent with GAAS, because the auditors would not accept computer generated records as competent evidence.⁷² The auditors should have accepted these valid business records. And, if they had tested the RBOCs’ internal controls, as they should have done, then they would have had a clear basis to rely on those records, rather than dismiss them entirely.⁷³

One of the main reasons allegedly showing that the audit procedures were biased in the RBOCs’ favor, according to AT&T and MCI, is that many of the “unverifiable items are likely to be missing.”⁷⁴ There are several problems with this line of reasoning. AT&T and MCI have no basis to assess the probability that “unverified” items ultimately would have been determined to be “not found” if the auditors had investigated these items further. It is pure speculation to claim that a significant portion of these should be “not found.” Given that the auditors were not sufficiently certain of the status of “unverified” to count them as “not found,” they should not be held against the RBOCs in any way. If an auditor is unsure or has conflicting evidence, he or she should pursue additional procedures before reaching any final conclusions.⁷⁵ Since the auditors

⁷⁰ Geppert Reply Declaration at 4.

⁷¹ *Id.* at 4-7, 8-10.

⁷² Ameritech at 17-18.

⁷³ *Id.*

⁷⁴ AT&T at 17-18; MCI at 12.

⁷⁵ *See* SBC LECs at 22-23. *See also* Geppert Reply Declaration at 4-7.

did not pursue the unverified any further, no conclusions or inference can be reached concerning these items.

In any event, through implementation of the SAVR inventory program at SWBT and Pacific, which the auditors have chosen to ignore, SBC has been able to verify the existence of its hardware equipment.⁷⁶

V. THE AUDIT PROCEDURES WERE TOO LIMITED TO PROVIDE A REASONABLE BASIS FOR AN OPINION ON THE ACCURACY OF THE ACCOUNT BALANCES UNDER GAAS.

Despite the irregularities identified by the RBOCs, AT&T maintains that the FCC auditors “fully complied with applicable GAAS and GAGAS auditing standards.”⁷⁷ However, AT&T and Mr. Loebbecke describe these audits as being limited in scope. For example, AT&T states that, “in light of the narrow focus of the Staff’s inquiry, the Staff’s audit is best described as special purpose audit, rather than a comprehensive audit of the RBOCs property accounts.”⁷⁸ According to Mr. Loebbecke this sort of limited engagement is similar in scope to an “agreed-upon procedures” engagement,⁷⁹ which is not a complete or comprehensive audit of financial statements or account balances.⁸⁰ In fact, in such an engagement, auditors are not required to follow all of the GAAS principles because the procedures would be “agreed upon.”⁸¹ For example, in Mr. Loebbecke’s analysis intended to show that the FCC auditors complied with applicable standards, he omits Standard of Field Work No. 3 that requires auditors to obtain

⁷⁶ See SBC LECs at 36-37, 41-42, 44-45.

⁷⁷ AT&T at 21.

⁷⁸ *Id.* at 21-22 n. 10.

⁷⁹ *Id.* Exhibit C, at 8-9, ¶¶14-15.

⁸⁰ See Geppert Reply Declaration at 2-4.

⁸¹ *Id.* at 4.